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to dramatically increase your property investing profits

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Your Notes

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Hi Matt, and welcome to your July edition of *'Insider'* - the PropertyInvesting.Com e-bulletin for positive cashflow investors seeking a lifetime of passive income from real estate.

This month's topics are:

1. My 5th Rule of Property Investing Success
2. Analysis Of A Potential Deal - What Is It That Can Make And Break A Deal?

As usual there is a lot to get through so let's get straight into it.

Last year I attended a 'get rich quick' seminar devised by a crafty American presenter. In it, a self-acclaimed property guru outlined his method of transforming real estate into a lifetime fortune using some kind of strategy where you purchased multi-family properties. "Easy money", he said. "It's easy money!"

At one stage, somewhere in between introducing himself and actually crying on stage, our so-called guru somehow magically (and to this day I don't know how!) turned $10,000 into $100,000 profit and had just about the entire room whipped into a frenzy.

But when I did a few quick calculations on the numbers behind his model, which were only glossed over during the presentation, it became clear that what he was talking about would be next to impossible to achieve here in Australia.

No matter which way or how hard I tried, I couldn't turn a property that consisted of 10 * $100,000 apartments (total $1m) into positive cashflow, (which the presenter said it was) when the rent was just $150 per week. I might as well have been trying to turn lead into gold.

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I walked away from that seminar feeling sorry for the people that purchased over $2,000 worth of product. They were going to learn a very valuable lesson about snake oil and unproven methods of making money.

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More so though, I wanted to devise a system of rules that could protect property investors from making an expensive mistake. That's when I devised my 10 Laws of Property Investing Success.

I have already outlined Rules 1 to 4 in earlier editions of this publication. These rules were:

1. Law #1 - Choose Your Investing Yardstick
   (see March 2002 edition)
2. Law #2 - What Has To Happen In Order For My Investment To Make Money?
   (see April 2002 edition)
3. Law #3 - Invest In Your Area of Expertise
   (see May 2002 edition)
4. Law #4 - Know Where You Stand In The Profit Pecking Order
   (see June 2002 edition)

Now it's time to reveal my fifth law of Property Investing Success, which is:

Appreciate Your True Cost and Your Nett Sale Proceeds

In real estate the price that you end up paying for your investment is not the figure written on the purchase contract. There are additional costs that must be paid for which commonly fall under the convenient heading of closing costs.

The biggest component of your closing costs is stamp duty. Stamp duty is a very lucrative government tax where the amount that you end up paying is determined by the State you live in, and depends on the contract price of the property you are purchasing.

Other closing costs include:

- Mortgage application fee
- Mortgage registration fee
- Property Valuation fee
- Legal costs for ensuring the property title correctly passes (the equivalent for this in the US is title insurance), and
- A whole pile of legal disbursements payable to ensure your property is not situated where a road is about to be built, title searches etc.

Statement of Adjustments

Settlement is the name given to the date on which title transfers from the vendor's name (ie. the person selling the property) into your (the investor's) name.

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A curious document that arises at settlement is something known as a Statement of Adjustments.

This document includes various additions and subtractions to the amount you end up paying for the property and includes items such as council and water rates pro rata to the date of settlement, legal fees etc. I have scanned in one of our Statement of Adjustments for you which you can see by clicking here

Almost always there is an amount that you will need to contribute by way of a bank cheque. For example, if you pay a 10% deposit and the bank will only lend you 80% of the purchase price, then you will need to contribute a further 10% on settlement, plus your closing costs which might be as high as a further 7.5% of the purchase price.

In some States (such as Queensland), Stamp Duty isn't payable on settlement (like it is in Victoria) - it is payable a designated number of days after the contract is signed.

One of the most important reasons for being able to identify your true cost of acquisition is because lenders won't generally fund your closing costs. A possible exception is if you are securing the new purchase against another property you own, in which case you are really doing a 100%+ loan.

This can be a rude shock when it comes time to organise a settlement cheque and you (all of a sudden) need to come up with another $10,000! More than one property investor I know has come unstuck at settlement and been forced to pay penalty interest at 18%+ while they madly phone a few friends to get the cash together.

There is a degree of psychological deception about what is truly paid for (when buying a property) that carries for the life of the deal. This is because (as you'll see in later discussion), the closing costs are never added to the contract price.

For example, if I asked you what you paid for your current home, or one of your investment properties, you could most likely tell me the contract price, but not the nett purchase price taking into account closing costs.

It seems that all investors - and me included from time to time - simply want to overstate how great the deal was and forget to include the closing costs. Instead they say, "I bought it for $80,000 and sold it for $110,000! What a fantastic investment!"

A more likely purchase price factoring in closing costs is about $85,000.

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For those investors with a truly negatively geared property, the actual cost is never amended for the loss associated with the after tax negative cashflow arising where expenses exceed income.

This can total thousands and thousands of dollars per annum, but it is blissfully ignored because it's just too nasty to accept and account for the true cost of an investment that consistently loses money.

The same deception that exists on buying also exists when you sell too, because from your sales price must be subtracted:

- Real estate agent (Realtor) commission
- Mortgage payout or discharge fees
- Early mortgage discharge penalties
- Legal fees
- Settlement adjustments, etc.

In the earlier basic example, the $110,000 sales price might be more like $103,000 once you pay out agent's commissions and other costs.

All of a sudden the profit has shrunk a massive 40% from $30,000 ($110,000 less $80,000), down to just $18,000 ($103,000 less $85,000).

Hopefully you can see the potential detrimental effect that closing and sale costs can have on your overall real estate profits.

I've found an excellent case study that demonstrates my point perfectly. It is the situation of a young couple that were recently featured on *'Location Location'*, a weekly Network Nine television show about buyers and sellers of real estate. The information below is sourced from their website, http://ninemsn.com.au/location/

It's the final open before the Newport house goes to auction and its time to see what the buyers think about our Location Location makeover. Despite the cold, blustery weather a few interested parties have turned up and they seem more than impressed by the significant transformation.

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The makeover has clearly added value to Trent and Caroline's two-bedroom cottage. Buyers are talking around the low $300 000 mark, which is a

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substantial increase from agent Paul's pre-makeover valuation of mid to high $200 000's.

But is that the price Trent and Caroline had in mind? Hours before the proceedings the couple sit down with their agent to discuss the all-important reserve. After outlining their intentions and reasons, they set an ambitious reserve of $340 000.

Meanwhile, a crowd is gathering outside their home. Agent Paul takes up his position as auctioneer and commences the auction. The first call is at $250 000 and it quickly climbs in ten thousand dollar bids. The bids push the price up $60 000 in six confident calls and then it stalls.

An anxious Paul calls $310 000 for the first time, then for the second. It looks like the hammer's about to go down, but a late bid of $315 000 comes for the crowd and it's not over yet.

The price climbs again until it reaches $325 000 and then the auction stalls once more. This time there are no more bids coming from the silent crowd. Paul's next move is to seek instruction off the vendors. And $15 000 below the reserve means Trent and Caroline are less than pleased.

Standing their ground the couple instruct Paul to try and get more money for their two-bedroom house. So, back outside he's working the crowd once again. A bid of a thousand dollars is called, closely followed three more one thousand dollar bids. At $329 000 the auction stalls, yet again.

It's time for negotiations with the highest bidder. Trent and Caroline are still looking for more money and that's when things start getting complicated. Another buyer enters the scene, and as negotiations proceed, two offers are made. One for $335 000 from an investor with a cash 30 day settlement, and the other at $336 000 with a 120 days settlement.

Trent and Caroline are leaning towards the quick settlement because moving later would interfere with the pregnancy. Then the camera shy bidder comes back with an offer of $500 less then her previous offer and a 30 day settlement instead of

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120 day. With the investor stepping aside, the offer is quickly accepted.

At the end of the day the house sold for $335 500 and Trent and Caroline had made a profit of almost $90 000 in just nine months. The makeover, coupled with a booming property market, helped produce a great result and the extra money will allow Trent and Caroline to upgrade and accommodate their growing family.

This is a good example because it summarises a wide range of emotions associated with both fear and greed - two dangerous emotions that all property investors need to keep in line. I had to laugh when I read "... the couple instruct Paul to try and get more money for their two-bedroom house." I can just imagine the conversation!

The point I'd like to draw out is that the article says that they made a profit of $90,000 in just nine months. This is almost certainly an unwitting deception - the true profit is likely to be much less.

Let's do some really quick "back of the envelope" numbers to see what's a more realistic figure. We'll assume that our homeowners took out an 80% loan at 7% variable interest only rate.

Purchase Price: $245,000 *($335,000 less $90,000)*
Stamp Duty: $11,860 *(calculated using tools at http://www.propertyinvesting.com/files/links.asp)*
Mortgage Application, Set Up etc: $1,000
Legal Fees, Disbursements: $1,000
Total Purchase Price: $258,860
Interest during nine months: $10,290
Rates etc. during nine months: $2,000

Adjusted Purchase Price: $271,150

Sales price: $335,000
Agent Commission: $13,400 (4% incl. marketing, etc.)
Legals: $1,000
Mortgage Payout: $500

Nett Sales Price: $320,100

Then we need to subtract the cost of the renovations which I don't know how much - say $20,000 - which means the real profit is something closer to about $25,000 than it is $90,000.

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Now I'm not saying that this is a bad outcome. A $25,000 profit (which is probably tax free if the couple had it as their principal place of residence) is a good outcome. My point is that a $90,000 profit can quickly be whittled down when you analyse the true cost of purchase and the true cost of sale.

My fifth law of Property Investing Success simply requires that you become realistic about your likely profit by considering the real (after closing cost) purchase price and the real (after sale cost) sales proceeds.

The best time to do this is when you complete your due diligence process over the numbers, since you can at least estimate the likely closing and sale costs.

Remember that the more information that you have at your disposal then the better educated your investment decision will be.

Post of the Month - A Potential Deal

One of the excellent posts made this month was from Peta, who asked my thoughts about a deal which she had sourced.

Her post reads:

Could I run the numbers of your suggested deal:

Buy for $60K
Rent at $135 pw = $7020 p.a.
Mortgage of say $50K with repayments at 7.5% = $3750 p.a.
Agents com. seems to be about 9-1/2% so say $650 p.a.
Rates and taxes, water etc. - unknown but say $1k p.a.
BodyCorp if any - unknown.

Income
Rent 7020

Outgoings

Mortgage 3750
Agents com. 650
Rates, etc. 1000
Repairs etc. 500

Total out. 5900

Therefore total income for one year is only $1-1500 p.a. and I have not yet allowed for stamp duty, legals and holding costs. Also how much are these types of property going to appreciate over

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time. I know the percentage return on cash on cash down may seem attractive, but is the "real" small return worth the exercise! Going forward you will have tenancy change over and agency lease fees.

May be Steve can help me clarify the figures 'cause every time I look at the cheap end of the market the real returns for the effort involved don’t seem to stack up unless I am buying a house to reno and add value.

Now if you pay it off over time and the rent says the same I guess you are deriving about a 9% net return but your money is tied up in an asset with limited growth.

Steve, have I missed something in these numbers, 'cause I see great deals all the time but when the numbers are crunched the "cheapies" potentially tie up too much of your investing dollar with limited growth opportunity. Peta

Peta, first of all, thanks for making your post on the Forum Board

The first test that I always run to ensure that it's worth taking more time to complete a due diligence on the numbers is the '11 Second Solution'. Based on the numbers that you have provided the answer is: ((135/2)*1000) = $67,500. Your purchase price is $60,000 so your deal meets this first benchmark.

From my experience, the agent's commission in the area where you talk about buying is certainly negotiable and 8% is probably a more realistic figure.

Depending on the condition of the property, I'd allow for say 5% maintenance.

But to be fair, I'd also build in three weeks vacancy into the rent.

My figures are more like:

Purchase Costs:

Contract price: $60,000
Closing costs: $3,500
Building inspection: $500
Total Purchase Costs: $64,000
Mortgage (80%): $48,000
Total Cash Needed: $16,000

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Income:

Rent (let 48 weeks): $6,480

Expenses:

Mortgage (P&I, 25 years, 7.5%): $4,247
Agent's Commission (8%): $520
Rates: $1000
Repairs (5%): $324
Total Expenses: $6,091
Nett Cashflow: $389
Nett Cash on Cash Return: 2.43%
Nett Cash on Cash Return if Fully Let: 5.38%
Nett Cash on Cash Return if Fully Let and Interest Only Loan: 6.72%
Interest if cash needed was invested at 5%: $800

My thoughts - the return is not worth the risk involved based on the parameters presented.

So this means that you need to be a little more creative about how you do things. At the upcoming Australian Masters of Property Investing I'll be canvassing a whole range of options that would make a property such as this one a lot more profitable.

For example, this property would lend itself perfectly for a wrap or lease option exit strategy.

However, if you wanted to keep it as a buy and hold (rental) then you need to consider strategies for achieving above market rent.

Without giving too much away about tactics you can use to increase rents, which is an important topic at the upcoming seminar, my suggestion is that if you offer what everyone else offers then you'll get what everyone else gets.

You need to offer some kind of other feature or service to your rental property that distinguishes it from other places and as such boosts your return.

I'll give you two quick examples...

First, one property that I looked at recently was a four bedroom property which would ordinarily rent for about $180 per week. However, for very little cost it would have been easily converted into two, 2-bedroom flats that would have rented for $110 per week each. This extra $30 per week equates to a further $1,560 on income per annum, which is quite significant!

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Second, the same property was located on a major road. There was a sign in the front yard that advertised a business down the road for which the owner received a further $500 each year as income. Added to the earlier additional rent, I could increase my return to more than $2,000 for very little effort.

There is an infinite number of ways that you can improve your yields, but what's necessary is thinking well outside the square.

People ask me "How do I find a property in Sydney that meets the 11 Second solution' - I say, "Look for opportunities that are outside the square and for problems that almost seem unsolvable and that's where you'll find your diamond in the rough."

Great deals exist everywhere, but you are going to have to work hard to squeeze every cent possible from it to get yields that others cannot.

Summary

This month I have allocated a lot of time and effort to fleshing out the important distinction between your contract purchase price and what the real cost is, and also what your contract sales price is and the true amount you're likely to receive as sales proceeds.

Remember that in the case of purchase costs, the rule is 'plus, plus, plus' and for sale proceeds it's 'less, less, less'.

Paying more and receiving less is not necessarily a problem provided you have accurately allowed for these costs during your due diligence over the numbers pertaining to your investment.

If you're lazy or don't know how to complete a due diligence then you may be in for a rude shock when it comes time to count your profits. For example, remember the example of our renovation friends, whose profits fell dramatically when you busted through the glossy figures and made a more realistic model.

I also fleshed out Peta's example which she posted on the forum board. If you want to know the area where Peta's deal was then you'll have to visit the forum and find her post! The bottom line in Peta's case was, like so many other positive cashflow deals, in order to gain a superior return she is going to have to think a little more creatively to differentiate herself from other rental properties. How to do this will be one of the key topics at the upcoming seminar.

Speaking of which, I'm looking forward to working with all the attendees at the 3rd and 4th of August event here in Melbourne.

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Until next month, best of success with your property deals and remember to only invest in things that make money.

May God bless you with good health and happiness,

Steve McKnight

P.S. If by some miracle you did not hear about the upcoming event then I encourage you to call Brent in the office on 1800 660 630 to find out more. Seats for the Melbourne event are just about all gone, but there are a few still available if you're quick for Sydney.

P.P.S. To access back-issues of this newsletters please go to: http://www.propertyinvesting.com/files/content.asp?cid=backissues